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Reporting pursuant to the Association for Investment Management and Research performance presentation standards; Statement of position 01-4;

American Institute of Certified Public Accountants. Investment Performance Statistics Task Force

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**STATEMENT OF
POSITION 01-4**



AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

November 13, 2001

**Reporting Pursuant to
the Association for
Investment Management
and Research Performance
Presentation Standards**

*Issued Under the Authority of the
Auditing Standards Board*

NOTE

This Statement of Position represents the recommendations of the AICPA's Investment Performance Statistics Task Force regarding the application of Statements on Standards for Attestation Engagements to engagements to report pursuant to the Association for Investment Management and Research Performance Presentation Standards. The Auditing Standards Board has found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations of this Statement of Position.

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Reporting Pursuant to the Association for Investment Management and Research Performance Presentation Standards

Introduction and Background

1. The investment management industry is composed of a diverse group of financial entities, including registered investment companies, investment partnerships (such as venture capital funds and hedge funds), registered and nonregistered investment advisers, commodity pool operators and trading advisers, commercial and investment banks, and trust companies. Despite diverse financial structures and regulatory environments, these entities share the common goal of maximizing the rate of return on assets being managed. A presentation of an investment firm's past performance in managing proprietary or client funds can be a powerful tool for attracting new clients and maintaining the firm's client base. In recent years, market forces, including rapid industry growth, significant consolidation, fierce competition, and increased scrutiny from regulators and investors, have resulted in an increased focus on these types of presentations.
2. To promote fair representation, full disclosure, and greater comparability in investment performance presentations, the Association for Investment Management and Research (AIMR) has developed the AIMR Performance Presentation Standards (AIMR-PPS[®] standards).¹ Although compliance with the AIMR-PPS standards is voluntary, an investment firm's claim of compliance with the AIMR-PPS standards is widely regarded as providing a competitive advantage. The

1. The term "Association for Investment Management and Research Performance Presentation Standards" is abbreviated in this Statement of Position either as the AIMR-PPS standards or the standards. For information on the appropriate use of the AIMR-PPS registered trademark [®], see the AIMR Web site <http://www.aimr.org>.

AIMR-PPS standards include both required and recommended guidelines for composite construction, calculation methodology, presentation of results, and disclosure. First introduced in 1987, the AIMR-PPS standards represent suitable criteria² on which investment managers can base their investment return calculations and present their results. AIMR's Performance Presentation Standards Implementation Committee and Investment Performance Council oversee the continuing development of the AIMR-PPS standards and the Global Investment Performance Standards (GIPS® standards).

3. In February 1999, AIMR issued the GIPS standards to provide a basis for readily accepted and comparable presentations of investment performance without regard to geographic location. At that time AIMR also took the first step in moving the AIMR-PPS standards toward a global investment performance standard by adding new requirements to bring them in line with the GIPS standards.
4. In May 2001, AIMR took the next step in converging the AIMR-PPS standards with the GIPS standards by adopting and publishing on its Web site redrafted AIMR-PPS standards, the U.S. and Canadian version of GIPS. Because the GIPS standards are fundamentally based on the AIMR-PPS standards, the redraft of the AIMR-PPS standards was primarily a reorganization of the existing provisions. The AIMR-PPS standards indicate that investment firms already compliant with the standards will need to perform minimal additional work to continue to comply with the AIMR-PPS standards. The AIMR-PPS standards incorporate all the requirements and recommendations of the GIPS standards. All references to the AIMR-PPS standards in this Statement of Position (SOP) refer to the redrafted AIMR-PPS standards, the U.S. and Canadian version of GIPS.

2. The AIMR-PPS standards provide suitable criteria, as defined in Chapter 1, "Attest Engagements," of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 2, AT sec. 101), for composite construction, calculation methodology, presentation of results, and disclosure. The criteria are available to users, as defined in Chapter 1 of SSAE No. 10, as they are posted to the AIMR Web site. The AIMR Web site also provides additional guidance on interpreting and applying the AIMR-PPS standards through a variety of means, including questions and answers, guidance statements, and subcommittee reports.

5. The AIMR-PPS standards recommend that firms obtain independent third-party verification of an investment firm's claim of compliance with the AIMR-PPS standards. Verification under the AIMR-PPS standards had previously consisted of two levels: Level I (firmwide verification) and Level II (verification of a specific composite). To encourage convergence of the AIMR-PPS standards and the GIPS standards, as of January 1, 2003, verification will only consist of the Level I procedures.³ In addition, an investment management firm may choose to have a more extensive, specifically focused performance examination of a specific composite presentation. It should be noted that AIMR's emphasis is on *firmwide* verification, which a firm *must* obtain concurrent with, or prior to, obtaining a performance examination of the performance results of any specific composite.
6. The AIMR-PPS standards specify that Level I verifications and performance examinations (Level II) must be performed by an independent third-party "verifier."

Scope

7. This SOP provides guidance to practitioners for engagements to examine and report on aspects of an investment firm's compliance with the AIMR-PPS standards (a Level I verification engagement). It also provides guidance on engagements to examine and report on the performance results of specific composites in conformity with the AIMR-PPS standards (a performance examination [Level II]). Such examination engagements should be performed pursuant to Chapter 1, "Attest Engagements," of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 2, AT sec. 101). As described herein, the AIMR-PPS standards require that such engagements use the criteria they set forth; consequently, users of this SOP should be familiar with the AIMR-PPS standards and interpretative guidance.

3. The requirements for a Level I verification under the AIMR-PPS standards are the same as those under the GIPS standards.

8. This SOP supersedes two AICPA Notices to Practitioners: *Examination Engagements to Report on Investment Performance Statistics Based on Established or Stated Criteria*, issued by the AICPA's Investment Companies Committee in November 1995; and *Engagements to Report on Performance Presentation Standards of the Association for Investment Management and Research*, issued by the AICPA Auditing Standards Division in July 1993. This SOP also supersedes paragraphs 11.18 through 11.22 of the AICPA Audit and Accounting Guide *Audits of Investment Companies*, Chapter 11, "Independent Auditor's Reports and Management Representations."

Overview of the AIMR-PPS Standards

Firmwide Compliance With the AIMR-PPS Standards

9. For an investment firm to claim compliance with the AIMR-PPS standards, the firm must meet *all* of the required elements of the AIMR-PPS standards on a *firmwide* basis. Firms are prohibited from claiming compliance "except for" one or more of the required standards. Firms that have met all of the required elements may include the following statement in performance presentations to clients:

[Insert name of firm] has prepared and presented this report in compliance with the Performance Presentation Standards of the Association for Investment Management and Research (AIMR-PPS®), the U.S. and Canadian version of the Global Investment Performance Standards (GIPS®). AIMR has not been involved in the preparation or review of this report.

10. The AIMR-PPS standards must be applied on a firmwide basis. The AIMR-PPS standards state:

A firm may define itself as

- a. an entity registered with the appropriate national regulatory authority overseeing the entity's investment management activities; or
- b. an investment firm, subsidiary, or division held out to clients or potential clients as a distinct business unit (e.g., a subsidiary firm or distinct business unit manag-

ing private client assets may claim compliance for itself without its parent organization being in compliance);

- c. (until January 1, 2005), all assets managed to one or more base currencies (for firms managing global assets).

When presenting investment performance in compliance with the AIMR-PPS standards, an investment management firm must state how it defines itself as a “firm.”

11. The AIMR-PPS standards establish both requirements and recommendations for investment firms to follow in preparing investment performance presentations. To claim firmwide compliance, an investment firm must adhere to the required standards. Adherence to the recommended standards is encouraged. The AIMR-PPS standards are divided into five sections that reflect the basic elements involved in presenting performance information:

Input Data: Consistency of input data is critical to effective compliance with the AIMR-PPS standards and establishes the foundation for full, fair, and comparable investment performance presentations. The standards provide the blueprint for a firm to follow in constructing this foundation.

Calculation Methodology: Achieving comparability among investment management firms’ performance presentations requires uniformity in methods used to calculate returns. The standards mandate the use of certain calculation methodologies (e.g., performance must be calculated using a time-weighted total rate of return method).

Composite Construction: A composite is an aggregation of a number of portfolios into a single group that represents a particular investment objective or strategy. The composite return is the asset-weighted average of the performance results of all the portfolios in the composite. Creating meaningful, asset-weighted composites is critical to the fair presentation, consistency, and comparability of results over time and among firms.

Disclosure: Disclosures allow firms to elaborate on the raw numbers provided in the presentation and give the end user of the presentation the proper context in which to understand the performance results. To comply with the AIMR-PPS standards, firms must disclose certain informa-

tion about their performance presentation and the calculation methodology adopted by the firm. Although some disclosures are required of all firms, others are specific to certain circumstances, and thus may not be applicable to all situations.

Presentation and Reporting: After constructing the composites, gathering the input data, calculating the returns and determining the necessary disclosures, the firms must incorporate this information in presentations based on the guidelines set out in the AIMR-PPS standards for presenting the investment performance results. No finite set of guidelines can cover all potential situations or anticipate future developments in investment industry structure, technology, products, or practices. When appropriate, firms have the responsibility to include in AIMR-compliant presentations information not covered by the Standards.

12. The AIMR-PPS standards also include four additional sections that address the calculation and presentation of performance for alternative asset categories (for example, real estate, venture and private placements, wrap-fee accounts, and after-tax returns).
13. Practitioners who perform a Level I verification or a performance examination (Level II) pursuant to the AIMR-PPS standards should be familiar with those standards and the interpretative guidance, which are available on AIMR's Web site.

Firmwide Verification and Performance Examination

Level I or Firmwide Verification

14. A Level I verification tests:
 - a. Whether the investment firm has complied with all the composite construction requirements of the AIMR-PPS standards on a firmwide basis; and
 - b. Whether the investment firm's processes and procedures are designed to calculate and present performance results in compliance with the AIMR-PPS standards.
15. Level I verification is considered to be the primary level of verification because it tests the validity of a firm's claim of

compliance on a *firmwide* basis rather than testing the claim for only one or more composites. Under Level I, a single verification report is issued with respect to the whole firm. The AIMR-PPS standards specify procedures that practitioners should perform for a Level I verification (see Section III and Appendix D of the AIMR-PPS standards; those procedures are reproduced in Appendix A of this SOP).

16. According to the AIMR-PPS standards, when an investment firm has obtained a Level I verification, the firm may state that it is “Level I verified.” This claim may or may not be accompanied by a presentation of performance history for a specific composite. A Level I verification, however, does *not* imply that the verifiers have examined the accuracy of the performance results of any particular composite presentation(s) that may accompany the verification report. (See paragraph 37.)

Performance Examination (Level II)

17. In addition to a Level I verification, an investment firm may choose to have a more extensive, specifically focused examination of a specific composite presentation. Such an examination, for the purposes of the AIMR-PPS standards, is referred to as a performance examination (Level II). The AIMR-PPS standards identify objectives and suggested procedures for a performance examination (Level II) (see Appendix B of this SOP). A performance examination (Level II) also requires a Level I verification to be performed prior to or concurrent with *any* performance examination (Level II).

Examination Engagement

Engagement Objectives

18. To satisfy the required procedures set forth by the AIMR-PPS standards, practitioners should conduct an examination engagement pursuant to Chapter 1 of SSAE No. 10. For a Level I engagement, the practitioner’s objective is to express an opinion on whether, in all material respects:
 - a. The investment firm has complied with all the composite construction requirements of the AIMR-PPS standards on a firmwide basis; and

- b.* The investment firm's processes and procedures are designed to calculate and present performance results in compliance with the AIMR-PPS standards.
- 19. For a performance examination (Level II), the practitioner's objectives include (*a*) expressing an opinion on a Level I engagement (see paragraph 18), and (*b*) expressing an opinion on whether the performance results of a specific composite are presented, in all material respects, in conformity with the AIMR-PPS standards.

Planning the Engagement

- 20. SSAE No. 10 states that planning an attest engagement involves developing an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, practitioners need to have sufficient knowledge of the investment management industry and of the AIMR-PPS standards and interpretive guidance to enable them to understand adequately the events, transactions, and practices that, in their judgment, have a significant effect on the subject matter of the assertions.
- 21. The examination should be conducted in accordance with attestation standards established by the AICPA. The engagement also should be conducted in accordance with the procedures set forth in the AIMR-PPS standards. This SOP is not intended to provide all the required and recommended procedures set forth in the AIMR-PPS standards or all the applicable attestation standards established by the AICPA.

Establishing an Understanding With the Client

- 22. The practitioner should establish an understanding with the client regarding the services to be performed to reduce the risk that either the practitioner or the client may misinterpret the needs or expectations of the other party. The understanding should include the objectives of the engagement, management's responsibilities, the practitioner's responsibilities, limitations of the engagement, and any other limitations on the use of the practitioner's name and report. The understanding should include a statement that, if the client intends to use the practitioner's report on the examination, or refer to the practitioner, in connection with any sales or

advertising literature, a draft of such literature should be provided to the practitioner for his or her review and comment prior to issuance.

23. The practitioner should document the understanding in the working papers, preferably through a written communication with the client, such as an engagement letter (see Appendix C of this SOP for a sample engagement letter).

Obtaining Sufficient Evidence

24. In conducting an attest examination, the practitioner accumulates sufficient evidence to restrict attestation risk⁴ to a level that is, in the practitioner's professional judgment, appropriately low for the high level of assurance that may be imparted by his or her report. A practitioner should select from all available procedures—that is, procedures that assess inherent and control risk and restrict detection risk—any combination that can restrict attestation risk to such an appropriately low level.
25. As noted previously, the AIMR-PPS standards specify procedures that practitioners should perform for a Level I verification in Section III and Appendix D of the AIMR-PPS standards; those procedures are reproduced in Appendix A of this SOP. Since a performance examination (Level II) requires a Level I verification, the practitioner should perform those procedures required for a Level I verification in *any* examination of a firm's investment performance prepared pursuant to AIMR-PPS standards. At a minimum, practitioners should follow the procedures required by the AIMR-PPS standards.
26. In addition, practitioners who are engaged to conduct a performance examination (Level II) of one or more specific composite presentations should consider the objectives specified in Appendix D of the AIMR-PPS standards in conducting a performance examination and should select from all available procedures any combination that can limit the risk of errors occurring and not being detected during the examination to an appropriately low level (see Appendix B

4. See SSAE No. 10, Chapter 1, paragraph 1.45, footnote 9, for the definition of *attestation risk*.

of this SOP for objectives and suggested procedures identified by the AIMR-PPS standards).

27. Regardless of the scope of the engagement, the practitioner should obtain sufficient evidence to provide a reasonable basis for the opinion expressed in the report (see the second standard of fieldwork in Chapter 1 of SSAE No. 10).
28. When the practitioner is engaged to conduct a performance examination (Level II) of one or more composites subsequent to the performance and issuance of a report on a Level I verification engagement, the practitioner should update his or her understanding of relevant controls and inquire about any other changes that may affect the planning and conduct of the performance examination (Level II).
29. The AIMR-PPS standards require that investment firms report, at a minimum, 10 years of investment performance (or performance since inception of the firm/composite if the period since inception is less than 10 years) to claim compliance with the standards. During a composite-specific performance examination, the practitioner should be alert for circumstances and events that affect prior period performance results presented or the adequacy of disclosures concerning those prior period performance results. In updating his or her report on the performance results for prior periods, the practitioner should consider the effects of any such circumstances or events coming to his or her attention. An updated report on performance results for a prior period should be distinguished from a reissuance of a previous report, since the practitioner, in issuing an updated report, considers information that he or she has become aware of during the examination of the current period performance results and because an updated report is issued in conjunction with the practitioner's report on the performance results for the current period. Although the investment firm must present 10 years of investment performance results, a Level I verification or a performance examination (Level II) can cover any time period.

Representation Letter

30. As part of a Level I verification, AIMR requires the practitioner to obtain a representation letter from the client firm

confirming major policies and any other specific representations made to the practitioner during the engagement. The practitioner also ordinarily should obtain a representation letter as part of a performance examination (Level II). Examples of matters that might appear in a representation letter include the following:

- a.* A statement acknowledging management's responsibility for their assertions and, where applicable, for the preparation of specific statements of performance results.
- b.* A statement acknowledging responsibility for selecting the criteria (SSAE No. 10, paragraph 1.60).
- c.* A statement acknowledging responsibility for determining that such criteria (AIMR-PPS standards) are appropriate for its purposes, where the responsible party is the client (SSAE No. 10, paragraph 1.60).
- d.* Management's assertions about (1) compliance with all the composite construction requirements of the AIMR-PPS standards on a firmwide basis, (2) the processes and procedures designed to calculate and present performance results in compliance with the AIMR-PPS standards, and (3) where applicable, a statement that the specific composite statements of performance results are presented in conformity with the AIMR-PPS standards. Management's assertions should address the same periods to be covered by the practitioner's examination report.
- e.* A statement that all known matters contradicting the assertions and any communication from regulatory agencies affecting the subject matter or the assertions have been disclosed to the practitioner.
- f.* A statement that there has been no (1) fraud involving management or employees who have significant roles in the company's processes and procedures relating to compliance with the AIMR-PPS standards or (2) fraud involving others that could have a material effect on the company's compliance with the AIMR-PPS standards.
- g.* Availability of all records relevant to the examination.

- h.* A statement that management is responsible for maintaining sufficient books and records to substantiate performance as required under Rule 204 of the Investment Advisers Act of 1940 and that management has maintained such records to comply with those requirements.
- i.* A statement that any known events subsequent to the period (or point in time) of the subject matter being reported on that would have a material effect on the subject matter or the assertions have been disclosed to the practitioner.
- j.* Other matters as the practitioner deems appropriate.

Appendix D of this SOP contains a sample management representation letter, including additional representations that may be appropriate for a performance examination (Level II). Management's refusal to furnish all appropriate written representations constitutes a limitation on the scope of the examination sufficient to preclude rendering an opinion (see paragraph 32 of this SOP). Further, the practitioner should consider the effects of management's refusal on his or her ability to rely on other management representations.

Reporting

- 31. SSAE No. 10 permits the practitioner to report either on the assertions or directly on the subject matter to which the assertions relate. The illustrative reports in Appendixes E and F present both reporting options.
- 32. After conducting the procedures for a Level I verification, the practitioner may conclude that the investment firm is not in compliance with the standards or that the records of the firm cannot support a complete verification. Practitioners should be aware that the AIMR-PPS standards state that "the AIMR-PPS Claim of Compliance statement can only be made on a presentation that fully adheres to the requirements of the AIMR-PPS standards." In such situations, the practitioner should issue a statement to the investment firm clarifying why it was not possible to issue a verification report; issuance of a qualified (except for) opinion is not permitted.

33. According to Chapter 1 of SSAE No. 10, when the practitioner is reporting on management's assertion, the practitioner's examination report should include an identification of the assertion and the responsible party. (When the assertion does not accompany the practitioner's report, the first paragraph of the report should also contain a statement of the assertion.)
34. The AIMR-PPS standards require that the report clearly indicate whether a Level I verification or a performance examination (Level II) has been performed. The AIMR-PPS standards also require that the report state the time period covered.
35. Appendix E presents illustrative reports for a Level I verification. Appendix F presents illustrative reports for a performance examination (Level II). The reports in Appendixes E and F also illustrate how the reference to a Level I verification or a performance examination (Level II), required by the AIMR-PPS standards, may be incorporated into the attest report.
36. The AIMR-PPS standards specify that conducting a Level I verification is a condition of conducting a performance examination (Level II); the examination report on the Level I verification may be issued prior to or concurrent with the performance examination report (Level II). Practitioners who conduct performance examinations (Level II) should report both on management's assertions about the subject matter of a Level I engagement and on the performance results of the specific composites that are the subject matter of the performance examination (Level II). The AIMR-PPS standards require that composite presentations that are the subject of a performance examination (Level II) report be attached to the report.
37. To avoid confusion to users of the report, the practitioner should add a paragraph to a Level I report disclaiming an opinion on the performance results of any specific composites that may accompany the report (see the Level I report in Appendix E). This recognizes that the practitioner cannot control whether the Level I verification report may be distributed by the investment firm as part of an AIMR-PPS standards-compliant composite presentation that has not also had a performance examination (Level II) conducted.

SOP Effective Date

38. This SOP is effective for engagements to examine and report on aspects of an investment firm's compliance with, and/or examining and reporting on specific composite results in conformity with, the redrafted AIMR-PPS standards, the U.S. and Canadian version of GIPS. The SOP may not be applied to engagements in which the investment firm has not yet adopted the redrafted AIMR-PPS standards.

APPENDIX A

AIMR-PPS Guidance for a Level I Verification

[Source: AIMR-PPS standards, Section III; www.aimr.org]

Level I verification under the AIMR-PPS standards is equivalent to GIPS verification. Therefore, all references to “the standards” below relate interchangeably to AIMR-PPS or GIPS standards. The following are the **minimum** procedures that verifiers must follow when verifying an investment firm’s claim of compliance with the standards. Verifiers must follow these procedures prior to issuing a verification report to the firm:

1. Pre-verification Procedures

- A. *Knowledge of the Firm.* Verifiers must obtain selected samples of the firm’s investment performance reports, and other available information regarding the firm, to ensure appropriate knowledge of the firm.
- B. *Knowledge of the standards.* Verifiers must understand the requirements and recommendations of the standards, including any updates, reports, or clarifications of the standards published by AIMR or the Investment Performance Council, the AIMR-sponsored body responsible for oversight of the GIPS.
- C. *Knowledge of the Performance Standards.* Verifiers must be knowledgeable of country-specific performance standards, laws, and regulations applicable to the firm, and must determine any differences between the standards and the country-specific standards, laws and regulations.
- D. *Knowledge of Firm Policies.* Verifiers must determine the firm’s assumptions and policies for establishing and maintaining compliance with all applicable require-

ments of the standards. At minimum, verifiers must determine the following policies and procedures of the firm:

- i. Policy with regard to investment discretion. The verifier must receive from the firm, in writing, the firm's definition of investment discretion and the firm's guidelines for determining whether accounts are fully discretionary.
- ii. Policy with regard to the definition of composites according to investment strategy; the verifier must obtain the firm's list of composite definitions with written criteria for including accounts in each composite.
- iii. Policy with regard to the timing of inclusion of new accounts in the composites.
- iv. Policy with regard to timing of exclusion of closed accounts in the composites.
- v. Policy with regard to the accrual of interest and dividend income.
- vi. Policy with regard to the market valuation of investment securities.
- vii. Method for computing time-weighted portfolio return.
- viii. Assumptions on the timing of capital inflows/outflows.
- ix. Method for computing composite returns.
- x. Policy with regard to the presentation of composite returns.
- xi. Policies regarding timing of implied taxes due on income and realized capital gains for reporting performance on an after-tax basis.
- xii. Policies regarding use of securities/countries not included in a composite's benchmark.
- xiii. Use of leverage and other derivatives.
- xiv. Any other policies and procedures relevant to performance presentation.

E. *Knowledge of Valuation Basis for Performance Calculations.* Verifiers must ensure that they understand the methods and policies used to record valuation information for performance calculation purposes. In particular, verifiers must determine that:

- i. the firm's policy on classifying fund flows (e.g., injections, disbursements, dividends, interest, fees, taxes, etc.) is consistent with the desired results, and will give rise to accurate returns;
- ii. the firm's accounting treatment of income, interest, and dividend receipts is consistent with cash account and cash accruals definitions;
- iii. the firm's treatment of taxes, tax reclaims, and tax accruals is correct, and the manner used is consistent with the desired method (i.e., gross- or net-of-tax return);
- iv. the firm's policies on recognizing purchases, sales, and the opening and closing of other positions are internally consistent and will produce accurate results; and
- v. the firm's accounting for investments and derivatives is consistent with the standards.

2. Verification Procedures

- A. *Definition of the Firm.* Verifiers must determine that the firm is, and has been, appropriately defined.
- B. *Composite Construction.* Verifiers must be satisfied that:
 - i. the firm has defined and maintained composites according to reasonable guidelines in compliance with the standards;
 - ii. all of the firm's actual discretionary fee-paying portfolios are included in a composite;
 - iii. the manager's definition of discretion has been consistently applied over time;
 - iv. at all times, all accounts are included in their respective composites and no accounts that belong in a particular composite have been excluded;
 - v. composite benchmarks are consistent with composite definitions and have been consistently applied over time;
 - vi. the firm's guidelines for creating and maintaining composites have been consistently applied; and
 - vii. the firm's list of composites is complete.

- C. *Non-Discretionary Accounts*. Verifiers must obtain a listing of all firm portfolios and determine on a sampling basis whether the manager's classification of the account as discretionary or non-discretionary is appropriate by referring to the account agreement and the manager's written guidelines for determining investment discretion.
- D. *Sample Account Selection*. Verifiers must obtain a listing of open and closed accounts for all composites for the years under examination. Verifiers may check compliance with the standards using a selected sample of a firm's accounts. Verifiers should consider the following criteria when selecting the sample accounts for examination:
- i. number of composites at the firm;
 - ii. number of portfolios in each composite;
 - iii. nature of the composite;
 - iv. total assets under management;
 - v. internal control structure at the firm (system of checks and balances in place);
 - vi. number of years under examination; and
 - vii. computer applications, software used in the construction and maintenance of composites, the use of external performance measurers and the calculation of performance results.

This list is not all-inclusive and contains only the **minimum** criteria that should be used in the selection and evaluation of a sample for testing. For example, one potentially useful approach would be to choose a portfolio for the study sample that has the largest impact on composite performance because of its size or because of extremely good or bad performance. The lack of explicit record keeping, or the presence of errors, may warrant selecting a larger sample or applying additional verification procedures.

- E. *Account Review*. For selected accounts, verifiers must determine:
- i. whether the timing of the initial inclusion in the composite is in accordance with policies of the firm;
 - ii. whether the timing of exclusion from the composite is in accordance with policies of the firm for closed accounts;

- iii. whether the objectives set forth in the account agreement are consistent with the manager's composite definition as indicated by the account agreement, portfolio summary, and composite definition;
 - iv. the existence of the accounts by tracing selected accounts from account agreements to the composites;
 - v. that all portfolios sharing the same guidelines are included in the same composite; and
 - vi. that shifts from one composite to another are consistent with the guidelines set forth by the specific account agreement or with documented guidelines of the firm's clients.
- F. *Performance Measurement Calculation.* Verifiers must determine whether the firm has computed performance in accordance with the policies and assumptions adopted by the firm and disclosed in its presentations. In doing so, verifiers should:
- i. recalculate rates of return for a sample of accounts in the firm using an acceptable return formula as prescribed by the standards (i.e., time-weighted rate of return); and
 - ii. take a reasonable sample of composite calculations to assure themselves of the accuracy of the asset weighting of returns, the geometric linking of returns to produce annual rates of returns, and the calculation of the dispersion of individual returns around the aggregate composite return.
- G. *Disclosures.* Verifiers must review a sample of composite presentations to ensure that the presentations include the information and disclosures required by the standards.
- H. *Maintenance of Records.* The verifier must maintain sufficient information to support the verification report. The verifier must obtain a representation letter from the client firm confirming major policies and any other specific representations made to the verifier during the examination.

APPENDIX B

AIMR-PPS Guidance for a Performance Examination (Level II)

[Source: AIMR-PPS standards, Appendix D; www.aimr.org]

With the goal to shift the focus of the industry to firmwide verification, the term “Level II verification,” which was previously an accepted form of verification under the AIMR-PPS standards, will be phased out on January 1, 2003. At that time, firms will no longer be able to state that a specific composite has been “Level II verified.” Instead, after January 1, 2003, the AIMR-PPS standards will allow firms that have received or are in the process of receiving a firmwide (Level I) verification report to have a further, more extensive performance examination or audit of a specific composite presentation. However, firms will not be able to make the claim that a particular composite has been “verified” but can claim that the composite returns have been examined or audited. The previous Level II verification procedures have been re-titled Performance Examination (Level II) and have been redrafted to focus on the need for the verifier to conduct and report a Level I verification in order to issue a Performance Examination (Level II) report. Once the term “Level II” verification is removed from the AIMR-PPS standards, “Level I” verification will simply be re-termed “verification.”

A. Scope and Purpose of Performance Examinations (Level II)

1. A Performance Examination (Level II) requires that:
 - i. The verifier follow all the verification procedures outlined for a Level I Verification and report on a Level I verification, and

- ii. Performance results of the specific composite being examined are presented in conformity with the AIMR-PPS standards.
2. A Performance Examination (Level II) Report is issued only with respect to the composite examined by the verifier and does not attest to the accuracy of a performance presentation for any other composite.
3. After performing the Performance Examination (Level II), the verifier may conclude that the presentation does not conform to the AIMR-PPS standards or that the records of the firm cannot support the composite presentation. In such situations, the verifier should communicate to the investment management firm the reason(s) why it was not possible to provide a Performance Examination report.
4. A principal verifier may accept the work of a local or previous verifier as part of the basis for the principal verifier's opinion.

B. Procedures for Performance Examinations (Level II)

Verifiers must conduct a Level I verification as outlined for a Level I (AIMR-PPS) verification (Section III) and issue a Level I verification report prior or concurrent to issuing a Performance Examination (Level II) report. A principal verifier may accept the work of a local or previous verifier as part of the basis for satisfying that a firm has previously received a Level I (AIMR-PPS) verification report.

When conducting an audit of a specific composite presentation, the verifier should consider the following presumptions, bearing in mind that they are not mutually exclusive and may be subject to important exceptions:

- Evidence obtained from independent sources outside an entity provides greater assurance about the subject matter or the assertion than evidence secured solely from within the entity.

- Information obtained from the verifier's direct personal knowledge (such as through physical examination, observation, computation, operating tests, or inspection) is more persuasive than information obtained indirectly.
- The more effective the controls over the subject matter, the more assurance they provide about the subject matter or the assertion.

In performing a performance examination, the verifier's objective is to accumulate sufficient evidence to limit the risk of errors occurring and not being detected during the audit to a level that is, in the verifier's judgment, appropriately low. A verifier should select from all available procedures any combination that can limit the risk of errors occurring and not being detected during the audit to an appropriately low level.

The extent to which the examination or audit procedures will be performed should be based on the verifier's consideration of (a) the nature and materiality of the information to be tested to the subject matter or the assertion taken as a whole, (b) the likelihood of misstatements, (c) knowledge obtained during current and previous engagements, (d) the extent to which the information is affected by judgment, and (e) inadequacies in the underlying data.

When conducting a Performance Examination or audit of a specific composite presentation, the verifier must consider the following objectives.

1. **Cash Flows:** Verifiers should determine whether capital contributions and withdrawals are recorded in the proper accounts, at the right amounts and on a timely basis. The following procedures should be considered:
 - i. On a test basis, agree cash flows to appropriate supporting documentation.
 - ii. Test contributions or withdrawals of securities to ensure proper valuation and timely recording.
 - iii. Consider the reasonableness and consistent application of the methods used to account for cash flows, contributions and withdrawals.

2. **Income and Expenses:** Verifiers should determine that income and expenses are recorded in the proper accounts, at the right amounts, and on a timely basis. The following procedures should be considered:
 - i. Agree significant income and expenses to supporting documentation such as custody statements.
 - ii. Evaluate the reasonableness and consistent application of the methods used to record income and expenses.
3. **Portfolio Trade Processing:** Verifiers should determine that purchases and sales of securities have been recorded in the proper accounts at the correct amounts on the appropriate dates. The following procedures should be considered:
 - i. On a test basis, agree significant trading activity to supporting documentation such as custody statements or trade tickets.
 - ii. On a test basis, agree significant end-of-period portfolio positions to supporting documentation such as custody statements.
 - iii. Evaluate the reasonableness of the portfolio trade processing system.
4. **Portfolio Valuation:** Verifiers should determine whether the end-of-period valuations of security positions are appropriate and that valuation policies are consistently applied. The following procedures should be considered:
 - i. On a test basis, agree significant end-of-period security valuations to an independent pricing source.
 - ii. On a test basis, agree significant foreign currency exchange rates to an independent pricing source.
 - iii. Evaluate the reasonableness and consistent application of the portfolio valuation methodology.
5. **Performance Measurement Calculation:** Verifiers should determine that the performance measurement statistics have been computed in accordance with the requirements contained in the AIMR-PPS standards on a consistent basis. The following procedures should be considered:

- i. On a test basis, test the computations of account returns to ensure the use of appropriate time-weighted return calculations.
 - ii. On a test basis, test the computations of composite returns to ensure the use of appropriate size-weighted return calculations.
 - iii. Evaluate the reasonableness and consistent application of the performance measurement calculation.
6. Other Disclosures: Verifiers should determine whether all required disclosures have been properly presented in the performance presentation and that disclosures are appropriately supported by available documentation. The following procedures should be considered:
 - i. Evaluate whether all of the required disclosure requirements have been adequately satisfied.
 - ii. Perform tests of required disclosures as deemed necessary. These tests could involve agreeing to supporting documentation, analytical procedures, or inquiry as appropriate.
 - iii. Evaluate the reasonableness and consistent application of the disclosures.

APPENDIX C

Sample Engagement Letter: Level I Verification and Performance Examination (Level II)

The following is an illustration of a sample engagement letter that may be used for this kind of engagement.

[CPA Firm Letterhead]

[Client's Name and Address]

Dear _____:

This will confirm our understanding of the arrangements for our examination of management's assertions that (1) [name of company] has complied with all the composite construction requirements of the Association for Investment Management and Research Performance Presentation Standards (AIMR-PPS® standards) on a firmwide basis for the [specify period] ending [date] and (2) the Company's processes and procedures are designed to calculate and present performance results in compliance with the AIMR-PPS standards as of [date]; this is referred to as a Level I verification under the AIMR-PPS standards. We have also been engaged to conduct an examination (referred to as a performance examination (Level II) under the AIMR-PPS standards) on the composite returns of [specify composites] of the Company for the [specify period] ending [date].

Our examination of management's assertions will be conducted in accordance with the attestation standards of the American Institute of Certified Public Accountants and with the criteria set forth in the AIMR-PPS standards. The Company is responsible for selecting the AIMR-PPS standards as the criteria against which we will evaluate its assertions and for determining that the AIMR-PPS standards are appropriate criteria for its purposes. The Company is responsible for compliance with all applicable

laws, regulations, contracts, and agreements, including the AIMR-PPS standards. The Company is also responsible for the design, implementation, and monitoring of the policies and procedures upon which compliance is based.¹ Our responsibility is to express an opinion based on our examination.

Should conditions not now anticipated preclude us from performing our examination procedures and issuing a report as contemplated by the preceding paragraph, we will advise you promptly and take such action as we deem appropriate.

Working papers that are prepared in connection with this engagement are our property. The working papers are prepared for the purpose of providing principal support for our report.

As you are aware, there are inherent limitations in the examination process, including, for example, selective testing and the possibility that collusion or forgery may preclude the detection of material errors, fraud, and illegal acts.

Our fees will be billed as work progresses and are based on the amount of time required at various levels of responsibility plus actual out-of-pocket expenses. Invoices are payable upon presentation. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees. The quoted fees assume that you will provide an accumulation of data for the year to be tested and that the records provided to us are clear, concise, and accurate.

In the event we are requested or authorized by Management or are required by government regulation, subpoena, or other legal process to produce our documents or our personnel as witnesses with respect to our engagement, the Company will reimburse us for our professional time and expenses, as well as any fees and expenses of our counsel, incurred in responding to such requests.

If the Company intends to use our report on the examination of the composite returns in whole or in part, or refer to [*name of CPA firm*], in connection with any sales or ad-

1. The independent practitioner may wish to include an understanding with the client about any limitation or other arrangements regarding liability of the practitioner or the client in the engagement letter.

vertising literature, a draft of such literature will be provided to us for review and comment prior to issuance.

Pursuant to our agreement as reflected in this letter, we will examine and report on the composites selected by you until either you or we terminate this agreement.

If these arrangements are acceptable, please sign one copy of this letter and return it to us. We appreciate the opportunity to serve you.

Very truly yours,

[Name of CPA Firm]

Accepted and agreed to:

[Client Representative's Signature]

[Title]

[Date]

APPENDIX D

Sample Management Representation Letter: Level I Verification and Performance Examination (Level II)

[Date]

[Name of CPA Firm]

We are providing this letter in connection with your examination(s) of the assertions of *[name of company]* that (1) the Company has complied with all the composite construction requirements of the Association for Investment Management and Research Performance Presentation Standards (AIMR-PPS® standards) on a firmwide basis for the 10-year period ended December 31, 20Y0, (2) the Company's processes and procedures were designed to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0, and (3) the Performance Results for Composite(s) *[specify composite(s)]* for the 10-year period ended December 31, 20Y0, are presented in conformity with the AIMR-PPS standards.

We confirm, to the best of our knowledge and belief, the following representations made to you during your examination(s):

1. We are responsible for (a) compliance with all the composite construction requirements of the AIMR-PPS standards on a firmwide basis for the 10-year period ended December 31, 20Y0, and (b) the design of the Company's processes and procedures to calculate and present performance results in compliance with the AIMR-PPS standards and have complied with those requirements as of December 31, 20Y0. We further confirm that we are responsible for the selection of the AIMR-PPS standards as the criteria against which you are evaluating our assertions. Further we confirm that we are responsible for determining that the AIMR-PPS standards are appropriate criteria for our purposes.

2. We assert to you that (a) we have complied with all the composite construction requirements of the AIMR-PPS standards on a firmwide basis for the 10-year period ended December 31, 20Y0, and (b) the Company's processes and procedures are designed to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0. We also assert that the Performance Results for ABC Composite for the 10-year period ended December 31, 20Y0, are presented in conformity with the AIMR-PPS standards.
3. We are not aware of any matters contradicting the assertions, nor have we received any communications from AIMR or regulatory agencies concerning (a) noncompliance with the AIMR-PPS standards or our assertions with regard thereto or (b) noncompliance with any other criteria relevant to investment performance statistics.
4. There has been no (a) fraud involving management or employees who have significant roles in the Company's processes and procedures relating to compliance with the AIMR-PPS standards or (b) fraud involving others that could have a material effect on the Company's compliance with the AIMR-PPS standards.
5. We have made available to you all records relevant to your examination of the aforementioned assertions.
6. We acknowledge responsibility for maintaining sufficient books and records as required under Rule 204 of the Investment Advisers Act of 1940 and we have maintained such records to comply with those requirements.

We are not aware of any events that occurred subsequent to the period being reported on and through the date of this letter that would have a material effect on the aforementioned assertions.

[Name of Chief Executive Officer and Title]

[Name of Chief Financial Officer and Title]

APPENDIX E

Illustrative Attest Reports: Level I Verification

Example 1: Reporting on Management's Assertions

Independent Accountant's Report

Ellerton Asset Management
1 Investors Square
Anywhere, USA

We have examined the accompanying management assertions of Ellerton Asset Management (the Company) for the 10-year period ended and as of December 31, 20Y0. These assertions are the responsibility of the Company's management. Our responsibility is to express an opinion on these assertions based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting management's assertions and performing the procedures for a Level I Verification set forth by the Association for Investment Management and Research Performance Presentation Standards (AIMR-PPS® standards)¹ and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, management's assertions referred to above are fairly stated, in all material respects, based on the AIMR-PPS standards.

1. The requirements for a Level I verification under the AIMR-PPS standards are the same as those under the GIPS standards; therefore, the practitioner may refer to the GIPS standards in an examination report on a GIPS verification, if requested.

We did not examine the performance results of the Company's composites for any period through December 31, 20Y0, including any performance presentations that may accompany this report and, accordingly, we express no opinion on any such performance results.

[Signature]

September 1, 20Y1

Example 1A: Illustrative Management's Assertions for Report Example 1

Ellerton Asset Management
1 Investors Square
Anywhere, USA

We assert that (1) we have complied with all the composite construction requirements of the Association for Investment Management and Research Performance Presentation Standards on a firmwide basis for the 10-year period ended December 31, 20Y0, and (2) the Company's processes and procedures are designed to calculate and present performance results in compliance with the Association for Investment Management and Research Performance Presentation Standards as of December 31, 20Y0.

[Signature]

John Q. Smith
Chief Executive Officer
Ellerton Asset Management

Example 2: Reporting Directly on the Subject Matter

Independent Accountant's Report

Ellerton Asset Management
1 Investors Square
Anywhere, USA

We have examined whether Ellerton Asset Management (the Company) (1) complied with all the composite construction requirements of the Association for Investment Management and Research Performance Presentation Standards² (AIMR-PPS[®] standards) on a firmwide basis for the 10-year period ended December 31, 20Y0, and (2) designed its processes and procedures to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0. The Company's management is responsible for compliance with the AIMR-PPS standards and the design of its processes and procedures. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the Company's compliance with the above-mentioned requirements, evaluating the design of the company's processes and procedures referred to above, and performing the procedures for a Level I verification set forth by the AIMR-PPS standards and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, Ellerton Asset Management has, in all material respects:

- Complied with all the composite construction requirements of the AIMR-PPS standards on a firmwide basis for the 10-year period ended December 31, 20Y0, and
- Designed its processes and procedures to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0.

2. The requirements for a Level I verification under the AIMR-PPS standards are the same as those under the GIPS standards; therefore, the practitioner may refer to the GIPS standards in an examination report on a GIPS verification, if requested.

We did not examine the performance results of the Company's composites for any period through December 31, 20Y0, including any performance presentations that may accompany this report and, accordingly, we express no opinion on any such performance results.

[Signature]

September 1, 20Y1

APPENDIX F

Illustrative Attest Reports: Level I Verification and Performance Examination (Level II)

Example I: Reporting on Management's Assertions

Independent Accountant's Report

Atlas Asset Management
10 Main Street
Anytown, USA

We have examined the accompanying management assertions of Atlas Asset Management (the Company) for the 10-year period ended and as of December 31, 20Y0. We have also examined management's assertion relating to the Company's ABC and XYZ Composites for the 10-year period ended December 31, 20Y0. These assertions are the responsibility of the Company's management. Our responsibility is to express an opinion on these assertions based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting management's assertions and performing the procedures for a Level I verification and a performance examination (Level II) set forth by the Association for Investment Management and Research Performance Presentation Standards (AIMR-PPS® standards) and such other procedures we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, management's assertions referred to above are fairly stated, in all material respects, based on the AIMR-PPS standards.

This report does not relate to any composite presentation of the Company other than the Company's ABC and XYZ Composites.

[Signature]

September 1, 20Y1

Example 1A: Illustrative Management's Assertions for Report Example 1

Atlas Asset Management
10 Main Street
Anytown, USA

We assert that (1) we have complied with all the composite construction requirements of the Association for Investment Management and Research Performance Presentation Standards on a firmwide basis for the 10-year period ended December 31, 20Y0, and (2) the Company's processes and procedures are designed to calculate and present performance results in compliance with the Association for Investment Management and Research Performance Presentation Standards as of December 31, 20Y0.

We also assert that the statements of performance results for the ABC and XYZ Composites for the 10-year period ended December 31, 20Y0, are presented in conformity with the Association for Investment Management and Research Performance Presentation Standards.

[Signature]

John Q. Jones
Chief Executive Officer,
Atlas Asset Management Company

Example 2: Reporting Directly on the Subject Matter (Level I and Performance Examination (Level II) Report)

Independent Accountant's Report

Atlas Asset Management
10 Main Street
Anytown, USA

We have examined whether Atlas Asset Management (the Company) (1) complied with all the composite construction requirements of the Association for Investment Research and Management Performance Presentation Standards (AIMR-PPS® standards) on a firmwide basis for the 10-year period ended December 31, 20Y0, and (2) designed its processes and procedures to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0. We have also examined the accompanying [*refer to title of accompanying statement*] of the Company's XYZ Composite for the 10-year period ended December 31, 20Y0. The Company's management is responsible for compliance with the AIMR-PPS standards and the design of its processes and procedures and for the [*refer to title of accompanying statement*]. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the Company's compliance with the above-mentioned requirements, evaluating the design of the company's processes and procedures referred to above, and performing the procedures for a Level I verification and a performance examination (Level II) set forth by the AIMR-PPS standards and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, Atlas Asset Management has, in all material respects:

- Complied with all the composite construction requirements of the AIMR-PPS standards on a firmwide basis for the 10-year period ended December 31, 20Y0, and
- Designed its processes and procedures to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0.

Also, in our opinion, [*refer to title of accompanying statement*] of the Company's XYZ Composite for the 10-year period ended December 31, 20Y0, is presented, in all material respects, in conformity with the AIMR-PPS standards.

This report does not relate to any composite presentation of the Company other than the Company's XYZ Composite.

[*Signature*]

September 1, 20Y1

Example 3: Reporting Directly on the Subject Matter (Performance Examination (Level II) Report With a Reference to a Separate Report on a Level I Verification)

Independent Accountant's Report

Atlas Asset Management
10 Main Street
Anytown, USA

We have examined the accompanying [*refer to title of accompanying statements*] of Atlas Asset Management's (the Company) ABC and XYZ Composites for the 10-year period ended December 31, 20Y0. The Company's management is responsible for these statements. Our responsibility is to express an opinion based on our examination. We previously conducted an examination (also referred to as a Level I verification) of (1) the Company's compliance with all the composite construction requirements of the Association for Investment Management and Research Performance Presentation Standards (AIMR-PPS® standards) on a firmwide basis for the 10-year period ended December 31, 20Y0, and (2) whether the Company's processes and procedures were designed to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0; our report dated August 7, 20Y1, with respect thereto is attached.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included performing the procedures for a performance examination (Level II) set forth by the AIMR-PPS standards and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, [*refer to title of accompanying statements*] of the Company's ABC and XYZ Composites for the 10-year period ended December 31, 20Y0, are presented, in all material respects, in conformity with the AIMR-PPS standards.

This report does not relate to any composite presentation of the Company other than the Company's ABC and XYZ Composites.

[Signature]

September 1, 20Y1

Investment Performance Statistics Task Force

James S. Gerson, *Chair*

Stephen D. Callahan

Herbert M. Chain

Matt Forstenhausler

Sean Keogh

Jessica Mann

Peter J. McNamara

John N. Spinney, Jr.

Karyn Vincent

AICPA Staff

Charles S. Landes

Director

Audit and Attest Standards

Jane M. Mancino

Technical Manager

Audit and Attest Standards

